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Ann E. Misback, Secretary
Board of Governors of the Federal Reserve
20th Street and Constitution Avenue
Washington, DC 20551

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Re: Implementation and Transition of the CECL for Allowances and Related Adjustments to the Regulatory Capital Rules and Conforming [R-1605]

To the Board of Governors:

This guidance is based on an incorrect understanding of accounting rules and may also possibly violate requirements pursuant to Section 121 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA). I urge regulators to take my comments seriously, since entire portions of the rule-making become inapplicable under a correct interpretation of existing accounting standards.[1]

A. Incorrect understanding of existing GAAP

The proposed changes to the agencies' definition of regulatory capital rely on wholly incorrect interpretations of FASB Statements No. 5, *Accounting for Contingencies* and No. 114, *Accounting by Creditors for Impairment of a Loan*. The proposal implicitly refers to requirements enumerated in these standards as part of an "incurred loss model" which is a term that isn't defined in the accounting or by the regulators. A lot of public capital is staked on the rules like this one, so regulators should precisely define "incurred loss", even if it is a term many people pretend to understand. Consider the attempt to explain the difference between CECL and existing GAAP:

> CECL requires [banks] to recognize *lifetime* expected credit losses for financial assets measured at amortized cost, not just those credit *losses that have been incurred* as of the reporting date. CECL also requires the incorporation of reasonable and supportable forecasts in developing an estimate of lifetime expected credit losses, while maintaining the current requirement for banking organizations to consider *past events and current conditions* [pg. 9]

It is fashionable to suggest that commercial banks were unable to make timely accruals for expected loan losses during the 2008 banking crisis as the "incurred loss model" prohibited accrual of expected losses and required estimates based on past or current events, even though the accounting standards are clear that this is not the case. For one, "event" is specifically defined as "any happening of consequence to an entity... it may be an event that involves interaction between an entity and its environment, such as transaction with another entity, a change in price of a good or service that an entity buys or sells". Housing crises, headlines of depression, and rising unemployment claims might count, for example. This is important because Statement No. 5 requires the accrual of a loss when it becomes probable that *future events confirm the loss or impairment of an asset.* In fact, Statements No. 5 and No. 114 require exactly that which the proposed rules believe it forbids, namely loss commensurate with uncollectible future cash flows.

- Statement No. 5, paragraph 23 requires that "if, based on available information, it is probable that the enterprise will be unable to collect all amounts due and, therefore, that at the date of its financial statements the net realizable value of the receivables through collection in the ordinary course of business is less than the total amount receivable, [the conditions for recognizing a loss] are met because it is probable that an asset has been impaired."
- Statement No. 114, paragraph 38 says of Statement No. 5, "For large groups of smaller-balance homogenous loans [collectively evaluated for impairment under Statement No. 5] creditors typically use a formula based on various factors... including past loss experience, recent economic events, current conditions, and portfolio delinquency rates... The Board presumes that while a formula approach does not explicitly discount expected future cash flows, *it results in a measure of impairment that implicitly discount expected future cash flows.*".
- Paragraph 43 and 51 go on to say "The Board concluded that this uncertainty of expected future cash flows is not a valid reason to ignore discounting and that failure to measure impaired loans on a discounted basis would not only be inconsistent with the manner in which unimpaired loans are measured but also would inappropriately ignore the time value of money... a loan impairment measurement should reflect only a deterioration of credit quality... evidenced by a decrease in the estimate of expected future cash flows to be received from the loan."

[1]For example, comments in the proposal like "under the capital rules, ALLL includes valuation allowances that have been established through a charge against earnings to cover estimated credit losses on loans... as determined in accordance with US GAAP. Under CECL, credit loss allowances [ACL] represent an accounting valuation account, measured as the difference between the financial assets' amortized cost basis and the amount expected to be collected on the financial assets (i.e. lifetime credit losses)" appear to be unaware of the fact that existing rules make it clear that "amount expected to be collected on the financial assets" is exactly what the ALLL is supposed to measure, which existing standards make unambiguously clear as explained in Section A.

It is therefore abundantly clear that as far as FASB is concerned, "losses that have been incurred based on past events" means the same thing as "losses" means a decline in the present value of future cash flows discounted at the original contractual interest rate. While the meaning of terms like "estimated loss" and "uncollectible amount" as used in Statement No. 5 are clear enough, and made more so by reiteration in Statement No. 114, general principles described in documents like FASB's Concepts Statement No. 7, "Using Cash Flow Information and Present Value in Accounting Measurements" make clear that:

- Generally, "the techniques used to estimate future cash flows and interest rates [may vary] however [should, to the extent possible] reflect assumptions about the future events and uncertainties that would be considered in deciding whether to acquire an asset or group of assets in an arm's length transaction for cash. "
- Similarly, estimated cash flows "should be free form both bias and factors unrelated to the asset in question".

Concepts Statement No. 7 more generally anticipates several erroneous conclusions less conscientious accountants have drawn about credit impairment, and illustrates the level of clarity lacking in statements like the one so proposed.[2]

B. Prescription of regulatory accounting principle less stringent than GAAP

Section 121 of FDICIA requires that "regulatory accounting principles [ought to be] no less stringent than generally accepted accounting principles" with respect to the objective of regulatory accounting reports that: (a) result in financial statements and reports of condition that "accurately reflect the capital of such institutions", (b) facilitate effective supervision of the institutions, and (c) facilitate "prompt corrective action" to resolve the institutions at least cost to the FDIC. The net effect of the proposed rulemaking on top of the already opaque and imprecise requirements enumerated within the CECL standard is the possibility of regulatory discretion unmoored from reality and accountability, and contrary to the objectives of FDICIA and possibly other Federal statutes.

- For example, per the the proposal for large banks following advanced approaches, total capital includes "any amount of eligible credit reserves that exceeds its regulatory expected credit losses to the extent that the excess reserve amount does not exceed 0.6 percent of the banking organization's credit risk-weighted assets" and the agencies "propose to revise the definition of eligible credit reserves to align with the definition of ACL in this proposal. Under the proposal, for an advanced approaches banking organization that has adopted CECL, eligible credit reserves would mean all general allowances that have been established through a charge against earnings or retained earnings to cover expected credit losses associated with on- or off-balance sheet wholesale and retail exposures, including ACL associated with such exposures".
- For three years after CECL comes into effect, "an electing advanced approaches banking organization that has completed the parallel run process would calculate an additional transitional amount to be phased into its eligible credit reserves (eligible credit reserves transitional amount)." to offset immediate inclusion in retained earnings arbitrary additional losses that will be required by CECL.
- This is in addition to further allowances for banks to add-back losses into Tier 2 capital, much like commercial banks were allowed to add back declines in accounting equity under the apparently incorrect premise that FDICIA requirements that regulatory capital measure capital somehow don't apply to changes in accounting equity that flow directly into stockholder's equity.

Regulatory forbearance to this effect is prohibited under FDICIA. If the agencies disagree, they should offer a clear legal opinion indicating their interpretation of FDICIA Section 121 as the it is quite clear about the objectives regulatory accounting standards ought to follow.

In any case, the proposed rules are either contradictory or meaningless, if not both — a claim easily verifiable by reading through cited paragraphs of the aforementioned accounting standards. While independent and transparent accounting is important for investors, their real importance *vis-a-vis* commercial banks is enforcing a disciplined corrective regime that Federal bank regulators cannot discard. In the absence of such controls, early signs of trouble are inevitably met with regulatory forbearance encouraging weak banks to defer recapitalization until they fail, as was the case with Citigroup and Bank of America, and Wachovia each of which were allowed to delay loan losses and other-than-temporary impairments required pursuant to GAAP to such an extent that they posted record levels of capital weeks before they each failed in Fall 2008.

Sincerely,

Ashok M. Rao

[2]In fact, Concepts Statement No. 7 anticipated precisely the sort of misconceptions on which the interagency guidance relies. 'The only objective of present value, when used in accounting measurements at initial recognition and fresh-start measurements, is to estimate fair value. Stated differently, present value should attempt to capture the elements that taken together would comprise a market price if one existed, that is, fair value. [...] When using estimated cash flow information, fair value measurements may appear to incorporate elements that could not be recognized under the provisions of Statement 5. For example, the fair value of a loan necessarily incorporates expectations about potential default, whereas under Statement 5, a loss cannot be recognized until it is probable that a loss event has occurred. Expectations about potential default are usually embodied in the interest rate, but they can also be expressed as adjustments to the expected cash flows (refer to Appendix A). Similarly, the amount that a third party would charge to assume an uncertain liability necessarily incorporates expectations about future events that are not probable, as that term is used in Statement 5. *However, the use of probable in the first recognition criterion of Statement 5 refers to the likelihood that an asset has been impaired or a liability incurred. The term does not reference the individual cash flows or factors that would be considered in estimating the fair value of the asset or liability.* '